

1-1-1962

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Recommended Citation

Robert H. Weir, *Two Tax Approaches in Disposing of Corporate Assets*, 2 SANTA CLARA LAWYER 1 (1962).
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Santa Clara Lawyer

Vol. II

WINTER 1962

No. 1

TWO TAX APPROACHES IN DISPOSING OF CORPORATE ASSETS

Section 337 and Subchapter S

*Robert H. Weir**

Certain tax problems attendant upon disposing of assets in a corporation are the matters to be dealt with in this article. The tax benefits of conducting business operations in the corporate form are well known to the average sophisticated businessman, who receives a good deal of written material about it from various sources. But in the evaluation of a proposed incorporation, the tax consequences which will result from a later need to depart from the corporate form deserve respectful attention.

The problems frequently present themselves in the field of real estate. A fairly typical situation is the manufacturing or food packing corporation that has decided to discontinue business operations because of changes in the area's economy. It finds itself holding substantially appreciated real property for which it has a relatively ready market. Another common example is the group that purchases land intending to construct a shopping center. In search of real or fancied tax advantages, the group incorporates and completes its development and holds the center in the corporation. As time goes on, the group is presented with an attractive offer to purchase the development. It goes without saying that in each of these situations the individuals involved want the sale effected in a fashion which will produce the least tax to the corporation and to the shareholders. The corporation in these cases intends to discontinue business operations.

There are, of course, various approaches to this problem. For example, the shares, rather than the assets, of the corporation could be sold. Practical business sense, however, frequently militates against this method because of the likelihood of unknown corporate liabilities.

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The examples posed here are generally resolved by the corporation's selling its assets and liquidating with a distribution of the proceeds to its shareholders. This technique, which can be stated with such deceptive simplicity, will now be examined in detail.

THE SITUATION BEFORE 1954

The Commissioner of Internal Revenue, who had won a major battle in 1945, found himself on the losing side in 1950. He thereafter engaged in a cold war with imaginative tax counsel until 1954 when the peace treaty introducing Section 337 of the Internal Revenue Code of 1954 became law.¹ For those who see the relevance of history as a means of insight into the present, here is how the tide of battle shifted.

In *Commissioner v. Court Holding Co.*,² a corporation with two shareholders had as its only asset an apartment house which it had held for about six years. Negotiations between the landlord corporation and its tenant and others took place and reached the point of oral agreement. The prospect of a substantial corporate tax motivated the parties to liquidate the corporation and divide the asset between the two shareholders in exchange for their stock. The former shareholders then entered into a contract to sell the building to the same purchasers using the cash deposit previously made in the corporate negotiations as a part payment of the purchase price under the contract to sell. The United States Supreme Court reversed the Court of Appeals and upheld the Tax Court which had found the "liquidating dividend" method was nothing more than a tax maneuver designed to make the transaction appear to be something different from what it in fact was, namely, a sale by the corporation. The Supreme Court reasoned from the familiar premise that substance rules over form and the substance must be determined by looking at the transaction as a whole rather than as a series of related fragments. The transaction was in substance a sale by the corporation and the gain was attributed to the corporation.

The Supreme Court spoke again in 1950 in *United States v. Cumberland Public Service Co.*³ A closely held corporation had been in the business of generating and selling electric power. Its shareholders offered to sell all of the stock to a competing cooperative which rejected the offer and countered with an offer to purchase the corporation's transmission and distribution equipment. The corporation refused because of the large tax it would have to pay. In order to avoid this tax at the corporate level,

¹ INTERNAL REVENUE CODE OF 1954, Section 337, entitled "Gain or Loss on Sales or Exchanges in Connection With Certain Liquidations."

² 324 U.S. 331 (1945), 33 AFTR 593, 45-1 USTC § 9215.

³ 338 U.S. 451 (1950), 38 AFTR 978, 50-1 USTC § 9129.

the corporation transferred the equipment to the shareholders as part of a liquidation, sold the balance of its assets and then dissolved. This procedure was carried out in the context of a prior acceptance by the cooperative of an offer to sell the equipment by the shareholders. The Court of Claims accepted the obvious fact that the form of the transaction was dictated by tax considerations,⁴ but took the position that the liquidation and dissolution genuinely ended the corporate activity and existence. Therefore the sale was that of the shareholders resulting in no tax at the corporate level. No one could be very surprised that doubts then arose about the effect of the *Court Holding Co.* decision. The Supreme Court granted certiorari in order to clear up the doubts. Its decision rested partially on the substantial invulnerability of fact findings by the trial court on appellate review. The Court realized that distinctions of the sort it was trying to draw could be "shadowy and artificial" and stated: "The oddities in tax consequences that emerge from the tax provisions here controlling appear to be inherent in the present tax pattern."⁵

What followed then was just what was to be expected. Tax advisors directed their efforts to creating fact situations in planning transactions that would rest on the "shadowy and artificial" distinctions necessary to avoid the "oddities in tax consequences."⁶

Congress realized this untenable situation and said so in a Report⁷ at the time of adopting Section 337 which stated that ". . . under present law the tax consequences arising from sales made in the course of liquidations may depend primarily upon the formal manner in which the transactions are arranged. Your committee intends in Section 337 to provide a definitive rule which will eliminate the present uncertainties."⁸ In a later Report, Congress again accented the pre-337 law as a "trap for the unwary" and stated that Section 337 had "made unimportant the formalities of the transaction."⁹

This history of a position almost diffidently taken by the Supreme Court, followed by Congressional action expressly taken to put an end to the formalism, would justify an expectation that the new Section 337

⁴ 83 F.Supp. 843 (Ct. Cl. 1949), 37 AFTR 1333, 49-1 USTC § 9259.

⁵ 338 U.S. 451, 455 (1950), 38 AFTR 978, 50-1 USTC § 9129.

⁶ See for example *Doyle Hosiery Corp.*, 17 T.C. 641 (1951), acq. 1952-2 CUM. BULL. 1, in which the taxpayer prevailed with five dissenting judges who stated that in their opinion "the sale was made by the petitioner [the corporation] and all that was done by the stockholders in their individual capacities was to indulge in carefully cloaked ritualistic formalities." *Id.* at 646-47. See also, SURREY & WARREN, CASES AND MATERIALS FEDERAL INCOME TAXATION, 1347-50 (1960 Ed.).

⁷ S. Rep. No. 1622, 83d Cong., 2d Sess. 258 (1954).

⁸ *Ibid.*; see H. R. Rep. No. 1337, 83d Cong., 2d Sess. A106 (1954), where almost the identical statement is made.

⁹ S. Rep. No. 1983, 85th Cong., 2d Sess. 29 (1958).

would be interpreted from a somewhat liberal point of view. This, however, has not always been the case with Section 337.¹⁰

SECTION 337

Generally stated, Section 337 provides that if a corporation adopts a plan of complete liquidation and, within the 12-month period beginning on the date of the adoption of the plan, disposes of all of the assets of the corporation (with some exceptions) in complete liquidation, then no gain or loss is to be recognized to the corporation from the sale or exchange by it of property within that 12-month period.¹¹ The obvious intent is to remove the tax at the corporate level and leave it at the shareholder level. For this reason, the provision is sometimes called the "Anti-Court Holding Co. Provision."¹²

The result is that a corporation which complies with the statute can sell some or all of its assets and distribute its proceeds to its shareholders with only one tax at the shareholder level on the distribution or cancellation of the stock. The relief afforded by Section 337 is limited only to property which can be generally classified as non-inventory items.¹³ The section's application is further limited in that it does not apply to

¹⁰ Consider the interpretation placed on Section 337 by the Internal Revenue Service in Rev. Rul. 56-387, 1956-2 CUM. BULL. 189, to the effect that an insolvent corporation which does not have sufficient assets to make any distribution to shareholders after payment to creditors cannot take advantage of Section 337 because Section 337 was created only for the benefit of shareholders.

¹¹ Section 337 of the INT. REV. CODE OF 1954 states in pertinent part:
"SEC. 337. GAIN OR LOSS ON SALES OR EXCHANGES IN CONNECTION WITH CERTAIN LIQUIDATIONS.

(a) GENERAL RULE. —If—

(1) a corporation adopts a plan of complete liquidation on or after June 22, 1954, and

(2) within the 12-month period beginning on the date of the adoption of such plan, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims,

then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period."

¹² BITTKER, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, 290 (1959).

¹³ "Property" is defined for purposes of Section 337(a) by Section 337(b) of INT. REV. CODE OF 1954 as follows:

(b) Property Defined.

(1) IN GENERAL.—For purposes of subsection (a), the term property does not include—

(A) A stock in trade of the corporation, or other property of a kind which would properly be included in the inventory of the corporation if on hand at the close of the taxable year, and property held by the corporation primarily for sale to customers in the ordinary course of its trade or business,

(B) installment obligations acquired in respect of the sale or exchange (without regard to whether such sale or exchange occurred before, on, or after the date of the adoption of the plan referred to in subsection (a)) of stock in trade or other property described in subparagraph (A) of this paragraph, and

certain transactions set forth in Section 337(c).¹⁴ These limitations are not relevant to this article except for the provision which makes Section 337 inapplicable to sales or exchanges by collapsible corporations, as defined in Section 341(b).¹⁵

The problems of collapsible corporations are far too complex to be analyzed here in detail.¹⁶ It should be sufficient for our purposes to realize that a collapsible corporation is generally one which has purchased, manufactured or constructed an asset which has appreciated in value and a substantial part of that appreciation has not yet been realized as taxable income.¹⁷ The gain recognized by a shareholder of any corporation falling into this category, whether by sale of his stock, liquidation, or distribution in excess of basis, will be taxed as ordinary income and not

(C) installment obligations acquired in respect of property (other than property described in subparagraph (A)) sold or exchanged before the date of the adoption of such plan of liquidation.

(2) **NONRECOGNITION WITH RESPECT TO INVENTORY IN CERTAIN CASES.**—Notwithstanding paragraph (1) of this subsection, if substantially all of the property described in subparagraph (A) of such paragraph (1) which is attributable to a trade or business of the corporation is, in accordance with this section, sold or exchanged to one person in one transaction, then for purposes of subsection (a) the term "property" includes—

(A) such property so sold or exchanged, and

(B) installment obligations acquired in respect of such sale or exchange.

¹⁴ Subsection (c) of Section 337 provides generally that that Section shall not apply to sales or exchanges of collapsible corporations as defined in Section 341(b) or to corporations which are liquidating under the special provisions of Section 333. It further limits the application of Section 337(a) in cases where the liquidating corporation is a subsidiary.

¹⁵ Section 337(c) provides in pertinent part:

(c) Limitations.

(1) Collapsible Corporation . . . This section shall not apply to any sale or exchange—

(A) made by a collapsible corporation (as defined in Section 341(b)) . . .

¹⁶ The taxation of gain from sale of stock, liquidation or distribution of assets in excess of shareholders' basis of collapsible corporations is governed by INT. REV. CODE OF 1954, § 341. The problems involved in construing Section 341 have been excellently treated in four articles by Irving I. Axelrad, *Axelrad, Collapsible Corporations and Collapsible Partnerships*, 1960 SO. CALIF. TAX INST. 269; *Axelrad, Recent Developments in Collapsible Corporations*, 36 TAXES 893 (1958); *Axelrad, Advantages and Pitfalls in Collapsible Corporations and Partnerships*, 34 TAXES 841 (1956); *Axelrad and Kostas, A Re-Examination of Collapsible Corporations "With a View to" Co-existing with Section 341*, 1956 SO. CALIF. TAX INST. 549.

¹⁷ To be a collapsible corporation under Section 341, the shareholders must have ". . . formed or availed of [the corporation] principally, for the manufacture, construction or production of property, for the purchase of [Section 341 Assets] . . . with a view to . . .

(A) the sale or exchange of stock. . . or a distribution to its shareholders, before the realization by the corporation . . . of a substantial part of the taxable income to be derived from such property . . ."

The provision seems to require a subjective element of intention to avoid taxes by use of the corporation but the Treasury Regulations have largely converted the test to an objective test by presuming that if the other facts exist the intent existed. *Treas. Reg. § 1.3412(a)(2)*. *Axelrad, Collapsible Corporations and Collapsible Partnerships*, 1960 SO. CALIF. TAX INST. 269, 283-292.

as capital gain.¹⁸ An exception to this treatment was adopted in 1958 as Subsection (e) of Section 341.¹⁹ It applies to corporations whose appreciated assets are not, generally speaking, dealer assets in the corporation's hands nor dealer assets in the hands of 20 per cent shareholders; nor, by virtue of broad attribution rules, dealer assets in the hands of the spouse, parent, child, brother, sister, spouses of lineal descendants, or partner of a 20 per cent shareholder; nor of a trust, estate, or partnership, of which a 20 per cent shareholder is a fiduciary, beneficiary, or member; nor in the hands of a person holding an option for 20 per cent of the shares.²⁰ If a corporation can come within the unbelievably complex rules of Subsection (e) then capital gain treatment can be achieved on sale of its stock.²¹ Section 337 will apply in such a case to a sale followed by liquidation within twelve months provided substantially all of the corporation's assets are sold to a wholly unrelated party, and no depreciable assets are distributed to shareholders.²²

The provisions of Section 341 have been grossly oversimplified by the foregoing description, but it will have served its purpose here if it has convinced the reader of the wisdom of providing a hedge against that section. Section 337 is often resorted to as just such a hedge. If the corporation sells all of its assets and then distributes the proceeds to the shareholders in an attempt to qualify under Section 337, the shareholder of a collapsible corporation can have at least the protection of a maximum effective rate of 47 per cent on the gain realized.²³ If the corporation is collapsible, Section 337 does not apply, and the gain on the corporation's sale is taxed to the corporation. Because all of the appreciation would then have been realized as taxable income, the corpora-

¹⁸ INT. REV. CODE OF 1954, § 341(a).

¹⁹ Section 20 (b), *Technical Amendments Act of 1958*, 72 Stat. 1620 (1958).

²⁰ In determining who are the owners of shares and how many shares they are deemed to own, Section 341(e)(10) states that Subsection (d) shall apply. Subsection (d), in turn, refers to Paragraphs (1), (2), (3), (5) and (6) of Section 544(a) with the added provision that for purposes of 544(a)(2), the "family of an individual shall include the spouses of that individual's brothers and sisters (whether by the whole or half blood) and the spouses of that individual's lineal descendants." By way of example of the absurdities which can result from such attribution rules, if a 20 per cent shareholder has a sister whose husband is engaged in partnership with a stranger who is a dealer, the corporation does not qualify as noncollapsible under Subsection (e). See Anthoine, *Federal Tax Legislation of 1958: The Corporate Election and Collapsible Amendment*, 58 COLUM. L. REV. 1146, 1193 (1958).

²¹ INT. REV. CODE OF 1954, § 341(e)(1) exempts such a sale from § 341(a)(1) if the requirements of Subsection (e)(1)(A), (B) and (C) are met. The sale would therefore be treated the same as the sale of stock of any corporation. In fact Subsection (e) of Section 341 requires only that the appreciation in value of dealer assets be not more than 15 per cent of the net worth of the corporation in order for the corporation to be considered as noncollapsible. In real estate corporations, however, allowance of a margin of 15 per cent will most likely have little, if any significance.

²² INT. REV. CODE OF 1954, § 341(e)(4).

²³ This method has been pointed out by several writers. See, for example, Axelrad and Kostas, *A Re-Examination of Collapsible Corporations "With a View to" Coexisting with Section 341*, 1956 SO. CALIF. TAX INST., 549, 605-606; Bennion, *Sale of Corpo-*

tion would no longer be collapsible and could then be liquidated with capital gain treatment.²⁴

The passage of Section 341(e) has to some extent reduced the area for which Section 337 is needed as a hedge. It is now possible to have the benefit of Section 337 provided the collapsible assets are not dealer items in the corporation nor the shareholders' hands. This assumes, however, a reliable solution to the problems of Section 341(e) mentioned above. Therefore, Section 337 is still useful as a hedge when the corporation does not want to sell substantially all of its assets,²⁵ or when the impact of the attribution rules cannot be ascertained with certainty. Furthermore, it may serve the same purpose where an item is a trade, business, or capital asset in the corporation's hands but a dealer asset in the hands of a 20 per cent shareholder.

The extent of this problem should be gauged from the fact that almost every closely-held corporation which holds appreciated real estate is potentially a collapsible corporation, and from the additional fact that one of the most litigated issues in tax law today concerns what real estate constitutes dealer property in the hands of its owner.²⁶ This explains why tax counsel often resort to Section 337 as a hedge against the confiscatory results which would occur if stock had been sold and the corporation were proved to be collapsible.

PLAN OF LIQUIDATION

In order to qualify for the tax benefits of Section 337, the corporation must adopt a plan of complete liquidation.²⁷ The Internal Revenue Code provides neither a definition of a plan of liquidation nor of what is meant by adoption of the plan by the corporation.

rate Assets under Section 337, 1958 SO. CALIF. TAX INST., 253, 277-78; 1 RABKIN & JOHNSON, *FEDERAL INCOME, GIFT AND ESTATE TAXATION*, 2355a-55b (1961).

The maximum rate of 43 per cent results as follows. Capital gain is taxed to the corporation at a flat rate of 25 per cent pursuant to Section 1201(a). On liquidation the amount of the gain less the 25 per cent tax paid by the corporation would presumably be subject to an additional capital gain tax at a maximum rate of 25 per cent pursuant to Section 1201(b). Mathematically this will result in a maximum 47 per cent on the gain realized from the sale of the corporate assets. See Weithorn, *Collapsible Corporations*: 1960 Status, N.Y.U. 19th INST. on Fed. Tax. 593, 609 n.50 (1961).

²⁴ Rev. Rul. 58-241, 1958-1 CUM. BULL. 179.

²⁵ In order for a corporation, which but for Section 341(e) is collapsible, to be eligible for the benefits of Section 337, it must comply with the requirements of Paragraph (4) of Subsection (e) which requires, among other things, that the corporation sell "substantially all of the properties held by it" within 12 months after the date it adopts a plan of complete liquidation. INT. REV. CODE OF 1954, § 341(e)(4)(B).

²⁶ Not only are the cases on this problem numerous but there is no discernable rule which would afford tax counsel any certainty in advising clients faced with the problem. In one case the Court of Appeals has described the myriad of cases dealing with the problem as follows: "Indeed, the case law has grown to a jungle-like abundance accompanied by much of the welter and impracticability which such fertility produces." *Kelley v. Commissioner*, 281 F.2d 527, 528, (9th Cir. 1960), 6 AFTR2d 5296, 297, 60-2 USTC § 9635. See Axelrad, *Collapsible Corporations and Collapsible Partnerships*, 1960 SO. CALIF. TAX INST., 269, 386-88.

²⁷ See note 10, *supra*.

The few cases on the subject have made it clear that a written resolution or plan formally adopted by the shareholders or directors is not required.²⁸ On the other hand, a mere intention to wind up and dissolve if a sale of assets should be made,²⁹ or the fact that dissolution was to be considered within the next few days³⁰ does not constitute a plan in the absence of a more definite program. Furthermore, a plan to liquidate the corporate assets does not necessarily require that formal steps be taken to dissolve the corporation.³¹ However, the resolutions setting forth the plan should be formally adopted and copies filed with Information Return Form 966³² and the corporation's income tax re-

²⁸ The Mountain Water Co. of La Crescenta, 35 T.C. 418 (1960), acq. 1961 INT. REV. BULL. No. 26, at 6; Intercounty Development Corp., 20 CCH Tax Ct. Mem. Dec. 24,963 (M), (July 31, 1961), (Dictum); Whitson v. Rockford, 190 F.Supp. 478 (D.N.Dak. 1960), 7 AFTR2d 301, 61-1 USTC § 9144 (Dictum).

Doubt as to this point existed prior to these cases, which had been contributed to by the decision of the tax court in Virginia Ice and Freezing Corporation, 30 T.C. 1251 (1958), discussed in note 30 *infra*. See Brookes, *Recent Developments in Corporate Liquidations*, 1960 So. CALIF. TAX INST., 233, 249-50; Note, *Liquidation of Closely-Held Corporations Under Section 337*, 16 TAX L. REV. 264 (1961). The rule stated in the cases seems in accord with the stated congressional purpose of Section 337 to avoid having formalities govern the tax effects, S. Rep. No. 1635, 83d Cong., 2d Sess. 258 (1954).

²⁹ Whitson v. Rockford, *supra*, note 28. The court held that the evidence failed to establish that a plan had been adopted prior to the sale. There was some evidence that liquidation was considered and would be desirable if a sale were consummated; however, the facts showed that no formal action was taken until 10 months after the sale.

³⁰ Virginia Ice and Freezing Corporation, 30 T.C. 1251 (1958). The corporation's directors authorized the sale of one of its eight ice plants at a loss on October 1, 1954, and on the same day set October 11 as the date for a directors' meeting to act on the matter of liquidation. On October 4 another ice plant was sold at a loss. On October 11 the directors adopted a plan to liquidate the remaining assets and dissolve and called a shareholders meeting for October 22, to approve the plan. On October 22 the shareholders approved the plan following which the remaining six plants and other assets were sold at a net profit. The Commissioner argued that a plan of complete liquidation had been informally adopted on October 1. The Court held that the plan was not adopted until the shareholders acted on October 22 and cited as authority the fact that under the local law ten days notice must be given for a directors' meeting to consider dissolution following which shareholder approval must be obtained. This portion of the Court's reasoning implied that formal steps toward dissolution were necessary for a plan to be adopted.

This case was described in The Mountain Water Co. of La Crescenta, *supra*, note 28, as having held that the loss sales were made "prior to the decision to sell all of the properties and liquidate." *Id.* at 424. It therefore appears that the case rested on the factual finding that a plan of liquidation, although obviously contemplated as a possibility, had not yet been made definite.

³¹ The Mountain Water Co. of La Crescenta, *supra*, note 28. See Burnside Veneer Co., 8 T.C. 442, *aff'd* 167 F.2d 214, (6th Cir. 1948), 36 AFTR 929, 48-1 USTC § 9237; Rev. Rul. 54-518, 1954-2 CUM. BULL. 142. *But cf.* Virginia Ice and Freezing Corporation, *supra*, note 30; and Rev. Rul. 58-391, 1958-2 CUM BULL. 139.

It appears, however, that once formal steps toward formal dissolution have been taken the corporation will be deemed to have adopted a plan of complete liquidation when those steps were taken. Shull v. Commissioner, 291 F.2d 680 (4th Cir. 1961), AFTR2d 61-2 USTC § 9535; Burnside Veneer Co., *supra*.

³² INT. REV. CODE OF 1954, § 6043 requires that every corporation shall within thirty days after the adoption of "a resolution or plan for the dissolution of the corporation or for the liquidation of the whole or any part of its capital stock" file an information return setting forth the terms of the resolution or plan. Treas. Reg. § 1.6043-1(a) requires that such information be reported on Internal Revenue Service Form No. 966.

turns,³³ even though failure to do so should not disqualify a corporation that can prove both an intention to liquidate the corporate assets and effectuating such an intention.³⁴

DATE OF ADOPTION OF PLAN

The more difficult problems under a plan of liquidation can be expected to arise in determining the date of adoption. The date of adoption is important for two reasons: first, only sales of property made within the 12-month period after this date will be ignored for tax purposes at the corporate level; and second, all of the assets must be distributed to the shareholders in complete liquidation within that period. In light of the fact that the statute has been construed as not requiring a formal plan, taxpayers can expect disputes in any but the clearest of cases. The regulations under Section 337, in defining the date of adoption of a plan of liquidation, cause confusion in that they can be interpreted as equating a plan of liquidation to a resolution of the shareholders to distribute assets in redemption of stock.³⁵ The regulation states:

Ordinarily the date of adoption of a plan of complete liquidation by a corporation is the date of adoption by the shareholders of the resolution authorizing the distribution of all the assets of the corporation (other than those retained to meet claims) in redemption of all of its stock.³⁶

Treas. Reg. § 1.6043-1(b) requires that a certified copy of the resolution be attached to the information return.

It is arguable that such a return need not be filed until a formal resolution to dissolve is adopted since the Code speaks only in those terms. It would follow that a return would not necessarily be required within 30 days after a plan were adopted in form of a resolution to dissolve.

³³ Treas. Reg. § 1.337-6 requires that copies of the minutes of the stockholders' meeting at which the plan of liquidation was formally adopted be attached to the liquidating corporation's tax returns. It is arguable that such information is not required by the regulations unless a plan of liquidation is "formally adopted." Treas. Reg. § 1.337-6(a)(1).

³⁴ The Commissioner does not appear to agree, however, for he is arguing in a case now pending in the Tax Court that the filing of an information return as apparently required by Section 6043 is a condition precedent to the applicability of Section 337. *Plaza Liquor Co., Inc.*, T.C. docket No. 88680, filed August 23, 1960. It is difficult to reconcile the Commissioner's position with this statement in a 1958 Senate Committee report: "Section 337 . . . made unimportant the formalities of the transaction." S. Rep. No. 1983, 85th Cong., 2d Sess. 29 (1958).

³⁵ This confusion appeared to exist in the court's opinion in *Virginia Ice and Freezing Corporation*, *supra* note 30. The confusion was dispelled in *The Mountain Water Co. of La Crescenta*, *supra* note 28. The Commissioner argued in the former case that a formal resolution to dissolve was not necessary to adopt a plan of liquidation, and lost. In the latter case he reversed his position and argued that a formal resolution adopted by the shareholders was necessary, and lost again. His acquiescence in *The Mountain Water Co.* case indicates that he is accepting the court's position that a formal resolution to dissolve is not necessary. *But see* Rev. Rul. 58-391, 1958-2 CUM. BULL. 139, holding that date of adoption of a plan of liquidation by the directors of an unincorporated association, taxable as a corporation, was the date of adoption of the plan of liquidation for purposes of Section 337, because the members had no power to vote on the plan.

³⁶ Treas. Reg. § 1.337-2(b).

The regulation should be read to mean that if a shareholders' resolution is adopted, then the date of the adoption of the resolution will "ordinarily" be the date on which the plan of liquidation is adopted.³⁷ The regulations continue the ambiguity as to the meaning of "plan" in the following statement, which is apparently inserted to allow a corporation some certainty in at least two situations:

Where the corporation sells substantially all of its property prior to the date of adoption by the shareholders of such resolution, then the date of the adoption of the plan of complete liquidation by such corporation is the date of the adoption by the shareholders of such resolution and gain or loss will be recognized with respect to such sales. Where no substantial part of the property has been sold by the corporation prior to the date of adoption by the shareholders of such resolution, the date of the adoption of the plan of complete liquidation by such corporation is the date of adoption by the shareholders of such resolution and no gain or loss will be recognized on sales of such property on or after such date, if all the corporate assets (other than those retained to meet claims) are distributed in liquidation to the shareholders within twelve months after the date of the adoption of such resolution.³⁸

The Treasury Department was apparently attempting to afford a corporation the choice of selling all of its assets outside of Section 337 or all of its assets within Section 337.³⁹ This would be in line with the intended flexibility of the statute, unless the interpretation, disapproved above, as to a shareholders' resolution being required, is placed upon the regulation.

Finally, the regulations state: "In all other cases, the date of adoption of the plan of complete liquidation shall be determined from all the facts and circumstances."⁴⁰ Here again the regulation is ambiguous. In the context of the foregoing quoted portions of the regulations, this rule can be read as applying only to "cases" where some assets are sold prior

³⁷ This would be in accord with the cases under other sections where the date of adoption of a plan of liquidation is important. See *Shull v. Commissioner*, *supra* note 31; *Burnside Veneer Co. v. Commissioner*, 167 F.2d 214 (6th Cir. 1948), 36 AFTR 929, 48-1 USTC 9237. It would seem, however, that the adoption of a resolution to dissolve would not be conclusive evidence that a liquidation was in process if no steps were taken to carry out the dissolution. See *W. F. Kennemer*, 35 B.T.A. 415, 421 (1937), *aff'd* 96 F.2d 177 (5th Cir. 1938), 21 AFTR 103, 38-1 USTC 9297; *W. F. Guild*, 19 B.T.A. 1186, 1204 (1930); Note, *Liquidation of Closely-Held Corporations Under Section 337*, 16 TAX L. REV. 255, 260-261 (1961); *but see*, the fifth sentence of Treas. Reg. § 1.337-2(b) stating that Section 337 will not apply if all of the corporation's assets are not distributed to shareholders "within twelve months after the date of adoption of a resolution by the shareholders authorizing the distribution of all the assets"

³⁸ Treas. Reg. § 1.337-2(b).

³⁹ BITTKER, *op. cit.*, *supra* note 12, at 292. *But see* Note, *Liquidation of Closely-Held Corporations Under Section 337*, 16 TAX L. REV. 255, 259 (1961), arguing that sale of all assets followed by adoption of a shareholders' resolution should fall within Section 337.

⁴⁰ Treas. Reg. § 1.337-2(b).

to the "required" shareholder resolution and some are sold after the resolution. The better interpretation, and the one the Tax Court has placed upon this sentence,⁴¹ is that "all other cases" means not only cases where sales straddle the shareholders' resolution to dissolve, but also cases where no shareholders' resolution is adopted and cases which are not "ordinary" even though a shareholders' resolution is adopted.

The Commissioner has given adequate warning to those who plan to unload assets at a loss before seeking the tax shelter of Section 337. In Revenue Ruling 57-146,⁴² the Internal Revenue Service ruled that certain loss sales pre-dated the adoption of a plan to liquidate only because it was clear from the facts presented that at the time of the loss sales "there was no intention, plan, or decision to liquidate. . . ." The implication was clear that had there been any intention to use Section 337 at the time the loss sales were made, the result of the ruling would have been different.⁴³ Consistent with this, the Commissioner argued in *Virginia Ice & Freezer Corporation*⁴⁴ that the plan was adopted at the time certain loss sales were made because at that date, which was shortly before the adoption of a plan of liquidation by the directors and shareholders, the directors had indicated they were going to consider liquidation of all assets. The Commissioner lost, apparently because he was unable to produce evidence of something more than a mere intention to consider liquidation and distribution of assets.⁴⁵

REVOKING A PLAN

Closely related to the question of formalities and date of adoption of a plan of liquidation, is the question of whether a plan may be revoked and at some later date a new plan adopted. It is clear that the 12-month period cannot be extended. Frequently in the sale of a business or improved real property, the buyer desires to condition the sale on an inspection and approval of the seller's books or leases. At the same time, both parties want assurances that the sale will be consummated if the conditions meet with the buyer's approval. Since Section 337 requires that a plan of complete liquidation be adopted prior to the sale, cautious taxpayers will adopt such a plan prior to the signing of any document.⁴⁶

⁴¹ The Mountain Water Co. of La Crescenta, *supra* note 28.

⁴² 1957-1 CUM BULL. 118.

⁴³ BITTKER, *op. cit. supra* note 12, at 293.

⁴⁴ 30 T.C. 1254 (1958).

⁴⁵ See note 30, *supra*.

⁴⁶ The regulations seem to allow the corporation leeway in such a situation by stating that "an executory contract to sell is to be distinguished from a contract of sale. Ordinarily, a sale has not occurred when a contract to sell has been entered into but title and possession of the property have not been transferred and the obligation of

If the sale is not consummated, can the plan be rescinded and at a later time a new plan adopted which will start anew the twelve months within which the sale must be made and assets distributed? There is very little authority on this issue. Two commentators state that the plan can be revoked without suggesting that any doubt exists.⁴⁷ It would appear, however, that since such a device would lend itself to abuse by extending the 12-month period where it appeared that more than twelve months would be required to make the desired sales, one can expect the Commissioner to scrutinize all such cases.

The regulations state only that the 12-month period will commence on the date of adoption of the plan and no extensions will be granted.⁴⁸ Since the regulations as to the date of adoption of the plan make reference to all of the facts and circumstances,⁴⁹ it is predictable that any attempt to use the revocation and readoption of plans to obtain more than twelve months will be attacked on the basis that the plan of liquidation was adopted on the earlier date.⁵⁰

The liberal legislative policy expressed in the committee reports would seem to call for a liberal rule with respect to rescinding a plan.⁵¹ When the contemplated sale fails, the test should be whether the original plan was in fact abandoned. Otherwise, it would be possible for a corporation to find that once it decided to sell its assets and distribute within twelve months to obtain the benefits of Section 337, it was still under the same

the seller to sell or the buyer to buy is conditioned." *Treas. Reg. § 1.337-2(a)*. Provisions of the type stated in the text would appear to make the obligation of the buyer conditional. It is doubtful whether the regulations are referring to a condition that title must be marketable or to other normal conditions of the type found in a real estate contract, as for example, those found in a deposit receipt. See SHAW, *WORKING WITH THE REVENUE CODE-1960*, at 71 (1960).

One writer has suggested that an option to buy be granted to the buyer with a provision that the buyer must give written notice a specified number of days before he may exercise the option, but the giving of such notice shall not bind the buyer to exercise the option. In this manner the corporation would have a greater amount of assurance that a sale was imminent before adopting a plan to liquidate. *CONTINUING EDUCATION OF THE BAR, ADVISING CALIFORNIA BUSINESS ENTERPRISES 1180-1181* (California Practice Handbook No. 9, 1958).

⁴⁷ 1 RABKIN & JOHNSON, *FEDERAL INCOME GIFT AND ESTATE TAXATION* 2376 (1961); SHAW, *WORKING WITH THE REVENUE CODE-1960*, at 71 (1960). (The statement regarding revocation of a plan was omitted from the 1961 edition of this work).

⁴⁸ *Treas. Reg. § 1.337-1*.

⁴⁹ *Treas. Reg. § 1.337-2(b)*.

⁵⁰ This would be particularly so when the first plan of liquidation is in the form of a shareholders' resolution to dissolve for *Treas. Reg. § 1.337-2(b)* in the fifth sentence states flatly that Section 337 shall not apply in any case where all the corporate assets are not distributed to stockholders within twelve months after "the date of the adoption of a resolution by the shareholders authorizing" distribution of assets in redemption of stock.

⁵¹ "In order to eliminate questions resulting only from formalities, your committee has provided that if a corporation in the process of liquidation sells assets there will be no tax at the corporate level . . ." H.R. Rep. No. 1337, 83d Cong., 2d Sess. 39 (1954). See also S. Rep. No. 1635, 83rd Cong., 2d Sess. 49, 258-59 (1954).

plan of liquidation as long as it was making efforts to sell its assets. Such a result would seriously depart from the purpose intended by Congress.

In any event, dramatic examples can be conjured up to demonstrate how absurd it would be to hold that adoption of a plan would thereafter affect the corporation even though the adoption of the second plan was made under changed business circumstances. Protection of the revenue would seem to require of the Government the position that nothing more is required than that the facts of a given case show that the revocation of the first plan and the subsequent adoption of a second plan were made for valid business reasons in order to accept the validity of the second plan for purposes of Section 337. If the "sales" under both plans were to different entities, this, alone, would seem to validate the procedure. Even if the negotiations were made with the same entities under both plans, that alone should not disqualify the second plan for Section 337 purposes. The negotiations might well have terminated in failure with a consequent revocation of the plan only to be started anew under some new or different business context which then enabled the negotiations to proceed to a sale.

AMENDMENT OF PLAN

Once a plan has been adopted and the corporation commences to carry out that plan, there appears to be no reason why the original plan may not be amended, provided that the corporate assets are distributed in complete liquidation within twelve months after the adoption of the original plan.⁵² The language of Section 337(a) does not seem to require that the assets be distributed to the shareholders in accordance with the exact plan of liquidation originally adopted, so long as the distribution is made within the required time.⁵³ A contrary rule would make the section almost unworkable in all but the simplest corporate liquidations.

TIMING OF DISTRIBUTIONS

Besides the plan of complete liquidation and the dates, there is additional tax planning which can be done for the corporation and its share-

⁵² One writer assumes, without discussing the question, that the plan may be amended. Paulston, *How to Plan and Execute the Sale of a Corporate Business Under the Internal Revenue Code of 1945*, 1956 SO. CALIF. TAX INST. 383, 440-41. It would be best, of course, to avoid the problem altogether by providing in the original plan that it may be amended. *Id.* at 439.

The regulations interpreting Section 6043, referring to information returns, see note 32, *supra*, contemplate amendments and supplements to a plan of liquidation. Treas. Reg. § 1.6043-1(a).

⁵³ See note 11, *supra*.

holders. For example, by delaying distribution of any assets until the commencement of the shareholders' next taxable year, the payment of any tax resulting from the liquidation can be deferred for a minimum of twelve months. Deferral of the tax may be quite important in the event that the purchase price for the corporate assets has not been paid in cash. Since the installment sale method of reporting the taxable gain will not be available to the shareholders, all of the gain on the liquidation will be recognized in the year of distribution of assets.⁵⁴

Nothing is contained in the Code or Regulation with respect to postponing distributions in order to push the tax forward an additional year. Presumably, the only limitation on planning for the distribution would be the doctrine of constructive receipt.⁵⁵ In view of the fact that many valid business reasons might well exist for delaying distributions,⁵⁶ it would appear that the Commissioner would not fare well under that doctrine in this type of case.

Spacing the distributions can achieve other benefits in addition to pushing the tax forward. It can be used to split the capital gain between two years so that the gain will be taxed in lower brackets.⁵⁷ It can be used to turn short term capital gain into long term capital gain for the shareholder who at the date of adoption of the plan of liquidation had not held his shares for more than six months.

In cases where the corporation is on the cash basis and the sale gives rise to interest bearing obligations of the buyer, it would appear that by waiting until the last possible date for distribution of the obligation to the shareholders the accrued interest can be converted from ordinary income to capital gain. In such a case, interest accrued prior to distribution to the shareholders should not be taxable to the shareholders when

⁵⁴ On liquidation the installment obligation will be taken at its full fair market value in determining the shareholders' gain. See Bension, *Sale of Corporate Assets Under Section 337*, 1958 So. CALIF. TAX INST. 253, 268-70. Tax to the corporation from the disposition of the installment obligation is avoided where Section 337 applies by virtue of Section 453(d) (4) (B).

If a shareholder can establish that the buyer's obligation has no fair market value at the time of distribution, he may use a cost recovery method of reporting gain. *Commission v. Carter*, 170 F.2d 911 (2d Cir., 1948), 37 AFTR 573, 48-2 USTC 9415. Litigation in such a case would be almost inevitable. See Treas. Reg. 1.453-4(a); Rev. Rul. 58-402, 1958-2 CUM. BULL. 15; BITTKER, *op. cit. supra* note 12, at 258; 2 RABKIN & JOHNSON, *op. cit. supra* note 48, at pp 4315-19.

⁵⁵ For the general doctrine of constructive receipt see 1 RABKIN & JOHNSON, *op. cit. supra* note 47, at 1209-10. But see *id.* at 2376 where the ability to delay distribution under Section 337 solely for the shareholders' benefit is questioned but without specification of a reason.

⁵⁶ For example, collection of accounts, payment of creditors, and enforcement of claims.

⁵⁷ When distributions are made pursuant to a plan of complete liquidation the shareholder is entitled to recover the full amount of his basis for all of his shares before he must report any gain. *Letts v. Commissioner*, 30 B.T.A. 800 (1934), *aff'd on other grounds*, 84 F.2d 760 (9th Cir., 1936), 18 AFTR 207, 36-2 USTC 9430.

received.⁵⁸ It is to be expected that the Commissioner will seek to tax this accrued income to the corporation under the theory of the anticipated assignment of income⁵⁹ or from his powers under Section 446 to compute income in the manner which "in the opinion of the Commissioner . . . clearly reflect(s) income."⁶⁰

Distribution of all the assets within twelve months can create problems for many real estate corporations if the sale has been made with the corporation receiving a purchase money deed of trust or mortgage as part of the purchase price. If the note, together with the deed of trust, is assigned to the shareholders in undivided interests, the problems of enforcing the note and deed of trust can become cumbersome. For example, all shareholders will have to sign a notice of default and, in the event of foreclosure, bidding at the sale can present numerous mechanical difficulties. It has been suggested that the shareholders, after receiving the troublesome asset, could transfer it to a trustee for their benefit to centralize its management.⁶¹ An agreement among the holders of the undivided interests authorizing majority control or appointing one person as agent could accomplish a similar objective.⁶² Any such arrangement, however, presents problems of an association taxable as a corporation⁶³ and the possibility of the entire transaction being classified as a reorganization nullifying the applicability of Section 337.⁶⁴

⁵⁸ The accrued interest will increase the fair market value of the obligation when received by the shareholder thus increasing his capital gain. A portion of the fair market value may be allocated to the accrued interest. When the interest is paid it is recovery of basis to the extent interest has accrued on the date of distribution.

⁵⁹ See Rev. Rul. 59-120, 1959-1 CUM. BULL. 74. In this ruling a cash basis corporation had made a bulk sale of discounted notes after adoption of a plan of liquidation. The Internal Revenue Service ruled that ordinary income must be recognized to the selling corporation to the extent of interest accrued prior to the sale.

⁶⁰ *Idaho National Bank v. United States*, 165 F.2d 6 (9th Cir. 1959), 3 AFTR2d 928, 59-1 USTC ¶ 9318; *Henry A. Kuckenberg*, 35 T.C. 473 (1960). See *J. Unger, Inc. v. Commissioner*, 244 F.2d 90 (2d Cir., 1957), 51 AFTR 250, 57-1 USTC ¶ 9678.

⁶¹ See SHAW, *WORKING WITH THE REVENUE CODE-1961*, at 68 (1961), where it is suggested by the author that a ruling should be obtainable to the effect that the liquidation is "complete" if the trustee is a liquidating trustee only. See 1 RABKIN & JOHNSON, *op. cit. supra* note 47 at 2378.

⁶² To alleviate problems such as these the American Bar Association, Section on Taxation, proposed an amendment to Section 337 to allow distribution to a liquidating trust or agency provided the trust or agency does not continue for more than 18 months after its creation without the consent of the Secretary or his delegate. A.B.A. SECTION ON TAXATION 1959 PROGRAM AND COMM. REPORTS TO BE PRESENTED AT THE NINETEENTH ANNUAL MEETING 53-54 (1959). This proposal was adopted by the Subchapter C Advisory Group of the House Ways and Means Committee. CCH STAND. FED. TAX REP. No. 11, March 3, 1959, *Advisory Group on Subchapter C of the Int. Rev. Code of 1954, Subcom. on Int. Rev. Taxation, House Comm. on Ways and Means, Revised Report on Corp. Distributions and Adjustments*, pp.55-56 (Dec. 9, 1958) [Hereinafter cited as *Subchapter C. Advisory Group Revised Report*]; Section 15, H.R. 4459, 86th Cong., 1st Sess. (Feb. 12, 1959).

⁶³ *SURREY & WARREN, op. cit. supra* note 5, at 1355.

⁶⁴ Section 337 will not apply in the event of a reorganization because a complete liquidation will not have occurred. BITTKER, *op. cit. supra* note 12, at 297-98.

See Rev. Rul. 61-156, 1961 INT. REV. BULL. No. 34, at 10.

As noted above, it is not necessary to a complete liquidation that the corporation be dissolved and the charter cancelled. However, the Service has recently ruled that reactivation of the corporation, even in a new business and presumably with assets different from those distributed, will nullify the effect of Section 337.⁶⁵ Under this ruling, it was stated that such a transaction would be treated as a partial liquidation, which means that the shareholders on distribution would be treated as having sold their stock for the assets distributed to them, but that the gain on sale of assets by the corporation would be taxed to the corporation.

It has also been suggested that the corporation during the 12-month period commencing with the adoption of a plan of liquidation can buy and sell securities or other assets without regard to the holding period requirements because the nature of the gain will depend upon the length of time the shareholders have owned their stock in the corporation rather than upon the holding period of the asset sold.⁶⁶ While there is no clear prohibition of this practice, it is doubted whether such conduct will be recommended by tax counsel. The injunction of the Code to adopt a plan of "complete liquidation" would appear to express a policy against the corporation's engaging in any new activity.⁶⁷ Unless the trading becomes active, it may well be that a passive form of investment pending distribution will not upset the required status of complete liquidation.

SALES TO RELATED ENTITIES

Previously, it appeared that a corporation could sell its assets to another corporation, the stock of which was at least partly owned by the same shareholders, and still qualify for Section 337.⁶⁸ The Internal Revenue Service has made it quite clear that such a sale will now be considered as a reorganization, and the cash or other property received by the shareholders on the liquidation of the selling corporation will be taxed as a dividend distribution resulting in ordinary income to the extent that the corporation had accumulated earnings and profits.⁶⁹

⁶⁵ Rev. Rul. 60-50, 1960-1 CUM. BULL. 150.

⁶⁶ SHAW, WORKING WITH THE REVENUE CODE—1961, at 71-72.

⁶⁷ See G.C.M. 6590, VIII-2 CUM. BULL. 169, 171 (1929).

⁶⁸ Rev. Rul. 56-541, 1956-2 CUM. BULL. 189, holding that Section 337 applied on a sale to a new corporation of which 45 per cent of the stock was owned by shareholders of the old corporation.

⁶⁹ In 1960, the Internal Revenue Service announced that it would not issue rulings where 50 per cent or more of the "voting stock of both the selling corporation and the purchasing corporation are owned by the same persons." Rev. Proc. 60-6, 1960-1 CUM. BULL. 880. On March 3, 1961, the Service amended its position to refuse to rule when "more than a nominal amount of the stock" of both corporations is commonly owned. T.I.R. 310, 617 CCH STAND. FED. TAX. REP. § 6325.

Finally, in Rev. Rul. 61-156, 1961 INT. REV. BULL. No. 34, at 10, Rev. Rul. 56-541, note 68 *supra*, was revoked. In Rev. Rul. 61-156 the Service held that sale of the assets of the liquidating corporation to a new corporation for cash, notes and 45 per cent of the new corporation's stock, when the new corporation immediately after the sale sold

The problems of what "property" is entitled to the tax free treatment⁷⁰ and what constitutes a sale or exchange under Section 337⁷¹ are beyond the scope of this article, as are the problems connected with realization of income from corporate liquidations in general which also exist under Section 337 liquidations.⁷²

PROPOSED LEGISLATION

Some mention should be made, however, of how recent legislative proposals would affect Section 337. In 1959, Representative Mills introduced the Corporate Distribution and Adjustments Bill of 1959,⁷³ which contained a complete overhaul of Subchapter C. The bill generally would have revised the approach to liquidations by limiting taxable gain or loss on a liquidation to the difference between the corporation's basis in the assets distributed and the shareholders' basis in the shares redeemed or cancelled.⁷⁴ When applied to a corporation which has just sold all or substantially all of its assets, the proposed rule would have the same tax effect as the existing rules.⁷⁵ For this reason, Section 337 was retained in the proposed revamping of Subchapter C except for minor changes.⁷⁶

This new approach to Subchapter C, however, would result in at least one significant advantage over the existing rules so far as a Section 337 situation is concerned. As pointed out above,⁷⁷ a corporation selling out and liquidating under the present Section 337 cannot obtain the

the other 55 per cent of its stock to the public, constituted a reorganization within the meaning of Section 368(a)(1)(E) and (F). The new corporation received no stepped up basis and the cash and notes distributed to the shareholders of the old corporation were boot and taxable as a dividend if accumulated earning and profits existed. Although these facts differ somewhat from Rev. Rul. 56-541, the Service stated the same principles should be applied to that case also.

See SHAW, *WORKING WITH THE REVENUE CODE*—1961, at 70-71, predicting the revoking of Rev. Rul. 56-541.

⁷⁰ See 1 RABKIN & JOHNSON, *op. cit. supra* note 47, at 2379-82 (1961).

⁷¹ See Bennion, *Sale of Corporate Assets Under Section 337*, 1958 SO. CALIF. TAX INST. 195, 270-271, 274-276.

⁷² 1 RABKIN & JOHNSON, *op. cit. supra* note 47, at 2356-2361 (1961).

⁷³ H.R. 4459, 86th Cong., 1st Sess. (Sept. 1, 1959).

⁷⁴ *Id.* at Section 12; SUBCHAPTER C ADVISORY GROUP REVISED REPORT 29-48

⁷⁵ In such event the basis of the corporate assets would presumably be equal to their fair market value except for installment obligation. Some doubt under the bill exists, however, since if Section 337 applied, gain to the corporation would be realized but not recognized. The normal rule imposed by the Internal Revenue Code is that in such case the basis of the assets received will be the basis of the assets sold or exchanged plus recognized gain only. *E.g.*, INT. REV. CODE OF 1954 §§ 351, 1031. See Brooks, *Recent Tax Developments in Corporate Liquidations*, 1960 SO. CALIF. TAX INST. 233, 264.

⁷⁶ Section 15, H.R. 4459, 86th Cong., 1st Sess. (Feb. 12, 1959), would amend Section 337 only to allow distribution to a liquidating trustee or agent (see note 61 *supra*), and to make the section applicable to involuntary conversions when a plan of complete liquidation is adopted within sixty days after the conversion. Both of these changes had been recommended by the American Bar Association Section on Taxation. A.B.A. SECTION ON TAXATION, *op. cit. supra* note 62, at 53-55 (1958).

⁷⁷ Note 54 *supra*.

benefits of the installment sale method in reporting for its shareholders. This is because the shareholders have to take up the full fair market value of the installment obligation when it is distributed to them. Under the new proposal, the shareholders would pay tax computed on the basis of the installment obligation rather than its fair market value. Basis of an installment obligation would generally be its face value less that portion of the gain which has not yet been recognized for tax purposes.⁷⁸ Apparently, therefore, when Section 337 applies, the shareholders would be able to utilize the installment sale method of reporting.⁷⁹

SUBCHAPTER S

The problems of Section 337 have led some tax men to explore Subchapter S as another avenue to avoiding tax at the corporate level.⁸⁰ It goes without saying that the Subchapter S concept is far broader than the restricted liquidation area of Section 337.

Subchapter S was adopted in September, 1958 as Section 64 of the Technical Amendments Act of 1958.⁸¹ According to the Committee Reports, it was intended to eliminate the influence of federal tax as a factor in choosing a form of business organization.⁸² Essentially, it permits corporate income to be taxed directly to the shareholders without tax at the corporate level.⁸³ In this respect, its result is similar to that of Section 337, and particularly so where a sale of all the corporation's assets is involved and there is no other corporate income during the particular period in question. Such a corporation, often called an "electing small business corporation," (hereafter referred to as ESBC), can pass to the shareholders the capital gain character of its income.⁸⁴

One is constrained to say, generally speaking, that Subchapter S is covered with bramble bushes through which a tortuous path can be dimly perceived.⁸⁵ Without warning of every branch likely to trip the unwary,⁸⁶

⁷⁸ INT. REV. CODE OF 1954, § 453(d) (2).

⁷⁹ This would be similar to the treatment afforded installment obligations when transferred to a decedent's successors. INT. REV. CODE OF 1954, §§ 453(d) (3), 691(a) (4).

⁸⁰ Axelrad, *op. cit. supra* note 23, at 365-72; Weithorn, *op. cit. supra* note 23, at 607-8.

⁸¹ Technical Amendments Act of September 2, 1958, 72 STAT. 1606, 1650 (1958).

⁸² S. REP. NO. 1983, 85th Cong., 2d Sess. 87 (1958).

⁸³ INT. REV. CODE OF 1954, § 1372(b).

⁸⁴ INT. REV. CODE OF 1954, § 1375(a) (1).

⁸⁵ Probably the most difficult obstacle is one transplanted from Subchapter C. The nebulous and elusive concept of earnings and profits which has given rise to numerous accounting problems under Subchapter C is used also in Subchapter S to determine the amount of, and the time that income is taxed to shareholders. Caplin, *Subchapter S vs. Partnership: A Proposed Legislative Program*, 46 VA. L. REV. 61 74-75 (1960); Andrews, "Out of its Earnings and Profits": *Some Reflections on the Taxation of Dividends*, 69 HARV. L. REV. 1403 (1956); INCOME TAX REVISION, PANEL DISCUSSION BEFORE THE COMMITTEE ON WAYS AND MEANS, 86th Cong., 1st Sess. 923 (Comm. Print. 1960) [hereinafter cited as PANEL DISCUSSION].

the limited portion of this subchapter which appears to parallel Section 337 will be compared. However, in this comparison the following facts should be assumed: (a) that the corporation is liquidating, that is, discontinuing operations; (b) that it is selling all or part of its fixed assets; (c) that it will shortly distribute its assets to the shareholders; and (d) that gain will be realized and recognized on the disposal of the assets, and, in the absence of either Subchapter S or Section 337, gain would be realized and recognized on the liquidation also. The resulting comparison, therefore, will be considered primarily in that context.

INSTALLMENT SALES

The installment sale fares badly under Section 337, which will not allow spreading gain over more than two years.⁸⁷ In many situations, it can be important to spread the gain. For example, the purpose may be either to take advantage of brackets lower than the alternative capital gain tax, to hedge against possible denial of capital gain treatment if the corporation's dealer status is in doubt, or to hedge against collapsible corporation issues which may be involved and which cannot be solved in some other manner.

Subchapter S does have the advantage of enabling the use of the installment method of reporting gain from the sale of the corporate assets, since it is not necessary to transfer the installment obligation to the shareholders as is the case with Section 337.⁸⁸ On the other hand, the ESBC must stay in existence at least as long as the balance of the installment period and must, at its peril, continue to qualify as an ESBC during that period. This can lead to problems of the sort discussed later in this article.

COLLAPSIBLE CORPORATION

We have seen that Section 337 is sometimes used as a hedge (especially in land corporations) against the collapsible issue. Subchapter S would seem to be of some use in this regard.

A sale of all the corporate assets by an ESBC seems to allow bypassing Section 341 (the collapsible corporation section) at least where the collapsible asset is not dealer property in the hands of such a corporation.⁸⁹ Actually, there need not occur any incident to which Section 341

⁸⁶ The general subject of the problems encountered is most thoroughly treated in Caplin, *op. cit. supra* note 85. See also Landis, *Advantages and Disadvantages of the Subchapter S Election*, N.Y.U. 18th Inst. on Fed. Tax. 723 (1960); Petty, *Qualification and Disqualification Under Subchapter S*, *id.* at 661; Valentine, *Taxation of Shareholders of Subchapter S Corporations During The Election Period*, *id.* at 689.

⁸⁷ See note 54 *supra*.

⁸⁸ *Ibid.*

⁸⁹ If the asset in question were dealer property in the corporation's hands its sale while a Subchapter S Election were in force would have much the same effect as a

applies. No sale of stock, no liquidation and no Section 301 distribution in excess of shareholder basis need take place. Therefore, capital gain could be realized by the ESBC and passed through to the shareholders under Section 1375(a)(1). This is most useful where the asset is a capital asset or a Section 1231(b) asset in the corporation's hands but a dealer asset in the hands of the shareholders. It appears that the dealer shareholder is allowed to avoid Section 341 altogether and, particularly, to avoid the need of trying to come within the incredible provisions of Subsection 341(e), with its esoteric inquiries and attribution rules. Of course, Subchapter S, by enabling the use of the installment method, permits a hedge where the dealer status is in doubt at either level.

As far as using Subchapter S to avoid Section 341 altogether, something which the literal statute appears to permit, the Treasury has inserted in the final regulations under Subchapter S, the principle of Section 341(e) adopted at the same time as Subchapter S.

Level for determining character of gain. Ordinarily, for purposes of determining whether gain on the sale or exchange of an asset by an electing small business corporation is capital gain, the character of the asset is determined at the corporate level. However, if an electing small business corporation is availed of by any shareholder or group of shareholders owning a substantial portion of the stock of such corporation for the purpose of selling property which in the hands of such shareholder or shareholders would not have been an asset, gain from the sale of which would be capital gain, then the gain on the sale of such property by the corporation shall not be treated as a capital gain. For this purpose, in determining the character of the asset in the hands of the shareholder, the activities of other electing small business corporations in which he is a shareholder shall be taken into consideration.⁹⁰

There is nothing in the code provisions (Sections 1371-1377) to support the Treasury's position, and commentators have questioned the validity of this regulation⁹¹ as one would expect. The Subchapter S Code Section which provides for capital gain treatment of ESBC dividends to the extent of net long term capital gain states:

The amount includible in the gross income of a shareholder as dividends . . . from an electing . . . corporation during any taxable year of the corporation, to the extent that such amount is a distribution of property out of earnings and profits of the

liquidation of a collapsible corporation. All of the appreciation would be taxed to the shareholders as ordinary income, since under Subchapter S the character of the gain is ordinarily determined at the corporation level. Treas. Reg. § 1.1375-1(d).

⁹⁰ Treas. Reg. § 1.1375-1(d).

⁹¹ E.g., Axelrad, *op. cit. supra* note 17, at 271-72; Landis, *op. cit. supra* note 86, at 734; Valentine, *op. cit. supra* note 86, at 691; Weithorn, *op. cit. supra* note 23, at 688; 1 RIA TAX COORDINATOR § D-1582 (1961). The proposed regulations, Prop. Reg. § 1.1372-1(a)(2), provided that a corporation in the process of liquidation or one which "contemplates . . . liquidation" was ineligible to elect under Subchapter S. The validity of this provision was also questioned by the commentators (see authorities cited *supra*) and was dropped in the adoption of final regulations.

taxable year . . . shall be treated as long term capital gain to the extent of the shareholder's pro rata share of the excess of the corporation's net long term capital gain over its net short-time capital loss for such taxable year.⁹²

The determination of the character of the gain is clearly to be made at the corporate, not the shareholder level.

There is nothing in the Committee Reports to support the Regulation. In fact, Chairman Mills in HR 9003 (introduced to the House Ways and Means Committee on September 1, 1959) would limit capital gain treatment to gains attributable to assets held by an ESBC for more than thirty-six months.⁹³

By way of further evidence, it is important to realize that Subchapter S does not generally provide for carry-through treatment of corporate income into the shareholder's hands. For example, tax-exempt interest income is not taxed to an ESBC, but when distributed to the shareholders, it is taxed as a dividend to them.⁹⁴ Congress, obviously, singled out capital gains for special treatment.⁹⁵

The Regulation is clearly patterned after Section 341(e) where consideration is given to the issue of whether corporate assets would be considered, in the hands of the shareholders, to be ordinary income items. But not even Section 341(e) attempts to ignore the corporate form to tax as ordinary income gain from assets, which in the corporation's hands are not dealer items, solely by virtue of their character in the shareholders' hands.

In determining whether a shareholder is a dealer, the business activity of other ESBC's of which he is a shareholder is attributed to him.⁹⁶ Why only other electing corporations?⁹⁷ Electing when? No attempt is made in the regulation to apply the attribution rules in determining who shall be considered as shareholders.

The collapsible net has a hole in it and it is understandable, although not commendable, that the Treasury has tried to terrorize taxpayers away from it. If nothing else, the Regulation means litigation for the taxpayer who tries to use Subchapter S to avoid the collapsible provisions of Section 341.⁹⁸

⁹² INT. REV. CODE OF 1954, § 1375(a)(1).

⁹³ H.R. 9003, 86th Cong., 1st Sess. (September 1, 1959).

⁹⁴ Tax exempt income will add to earnings and profits and will bring about dividends when distributed to shareholders. Treas. Reg. § 1.1377-2(b). Caplin, *op. cit. supra* note 85, at 64.

⁹⁵ S. Rep. No. 1983, 85th Cong., 2d Sess. 221 (1958).

⁹⁶ Treas. Reg. 1.1375-1(d).

⁹⁷ Section 341(e), in determining dealer status, imputes to the shareholders transactions of the shareholders through other corporations which would otherwise fit under § 341(e). For some illogical reason, Treas. Reg. § 1.1375-1(d) was hammered into the same pattern.

⁹⁸ Subchapter S may be very helpful in several situations, however, where there is no dealer problem either for the corporation or the shareholder, but the corporation is

PARTIAL LIQUIDATIONS

When the problem is to dispose of only part of the corporation's assets, Section 337 has disadvantages. It requires total liquidation of the attendant tax on all of the assets.⁹⁹ The alternative of contracting the business operation and distributing part of the assets will breed dividend problems unless the taxpayer can squeeze within the limitation of Section 346.¹⁰⁰

Subchapter S, with limitations, can be used to avoid tax at the corporate level from this disposal of part of the business while, at the same time, avoiding tax on the part retained.¹⁰¹ This technique would be useful only with a sale, since a distribution of corporate property (distribution in kind) to the shareholders of an ESBC gives rise to special problems. In the presence of current or accumulated earnings and profits in excess of taxable income, a distribution in kind by an ESBC will result in more income being taxed to the shareholder than would have been taxed to a non-electing corporation shareholder using the same technique.¹⁰²

SALES TO RELATED ENTITY TO ACHIEVE STEPPED-UP BASIS

Sometimes Section 337 has been used where the sale of the corporation's assets was to another corporation owned by the same stockholders. The following situation has occasionally presented itself: An investment corporation owning income real estate leases it to an operating corporation. If the investment corporation's assets have been substantially depreciated, or if the operating corporation has substantial accumulated cash, it is advantageous for the investment corporation to adopt a plan of complete liquidation to sell its real estate for cash to the operating corporation and

still collapsible. Such a case would exist where § 341(e) would apply but the attribution rules as to stock ownership make the corporation ineligible for 341(e).

Subchapter S can also be used to sell assets where a corporation is still collapsible under § 341(a) such that § 337 does not apply, but stock could be sold at capital gains, because the exceptions of § 341(d) apply. INT. REV. CODE OF 1954, § 341(d)(2) [70 per cent rule], and § 341(d)(3) [3 year rule]. See Driscoll, *Subchapter S - Its Role in the Tax Laws*, 3 TAX REVISION COMPENDIUM SUBMITTED TO THE COMM. ON WAYS AND MEANS, 86th Cong., 2d Sess. 1723, 1728 (Comm. Print 1959).

⁹⁹ INT. REV. CODE OF 1954, § 337(a)(2). See Rev. Rul. 60-50, 1960-1 CUM. BULL. 150.

¹⁰⁰ See Pennell, *New Ideas in Disposing of Part of a Business*, N.Y.U. 19TH INST. ON FED. TAX. 529 (1961). BITTKER, *op. cit. supra* note 12, at 214-223. Even if the partial liquidation requirements are met a double tax will be incurred as in *Court Holding Co. v. Commissioner*, *supra* note 2.

¹⁰¹ Pennell, *op. cit. supra* note 100, at 548-553. It would even seem possible to sell part of the assets and pay a tax at the shareholder level by electing Subchapter S and then liquidate tax free under Section 333. This would be practical only if no accumulated earnings and profits existed. Liquidation under Section 333 prior to selling off part of the assets gives rise to the *Court Holding Co.* problems which existed prior to 1954.

¹⁰² Treas. Reg. § 1.1373-1(g) Example (4). Pennell, *op. cit. supra* note 100, at 551-52. The reasons for this result are extremely complex because of the manner in which current earnings and profits are allocated for distribution in kind. See Treas. Reg. § 1.1373-1(e). Caplin, *op. cit. supra* note 86, at 68.

dissolve the investment corporation. Under Section 337, there would be no tax at the corporate level; the cash proceeds would be distributed to the shareholders at capital gain rates, assuming a gain, and the operating corporation would have a basis in the depreciable real estate equal to its cost for the property.¹⁰³ As indicated above, this had been thought by some to be a safe procedure until this year when the Service issued a new ruling revoking its previous position and indicating that such a transaction would be a reorganization.¹⁰⁴ If the transaction is a reorganization, the buying corporation will not have a stepped-up basis and the liquidation of the selling corporation will result in dividends to the shareholders.¹⁰⁵

Conceivably, the stepped-up basis can be achieved by having the investment corporation elect to be an ESBC and then sell its real estate to the operating corporation. This would permit a pass-through of cash to the shareholders only to the extent of the gain because, as assumed, there would be accumulated earnings and profits. Any distribution in excess of the gain would be taxed as a dividend unless the corporation liquidated. But if it liquidated, then it would probably face the reorganization problem.¹⁰⁶ Of course, the sale from the investment corporation would have to be made early in its Subchapter S year in order to comply with the requirement that less than 20 per cent gross receipts be from rent.

PRICE OF AVOIDING TECHNICAL PROBLEMS

The Section 337 problems dealt with in this article are largely avoided by Subchapter S. For example, there need be no concern over the date of adoption of the plan, nor about distributing all of the assets within the 12-month period. When these problems present themselves in a Section 337 context, then Subchapter S should be considered. That consideration must include respect for the complexities surrounding Subchapter S,¹⁰⁷ the full extent of which is far too broad for this article to cover. Concern here is restricted to what can be called the "one-shot election," or that area of Subchapter S involved where an election is made as a substitute for Section 337 in the sale of assets and distribution of proceeds.

¹⁰³ 1 RIA TAX COORDINATOR § D-1585 (1961).

¹⁰⁴ See note 68 *supra*.

¹⁰⁵ Rev. Rul. 61-156, 1961 INT. REV. BULL. No. 34, at 10.

¹⁰⁶ *Ibid.*; Rice, *When is a Liquidation not a Liquidation for Federal Income Tax Purposes?* 8 STAN. L. REV. 208, 212-14, 222-28 (1956).

¹⁰⁷ See authorities cited in note 86 *supra*. Mortimer M. Caplin, now Commissioner of Internal Revenue, in testifying before the House Ways and Means Committee in 1959 stated: "On the technical level Subchapter S creates complexities and some of them are indefensible and inequitable. Despite 1 year's experience under this Subchapter, it is my belief that Congress would be justified in striking it from the code as bad law, not worthy of retention in modified form." PANEL DISCUSSION 922.

ELIGIBILITY

Subchapter S is a restricted membership club on a narrow base. The requirements are strict and they must all be satisfied at the start of and at all times during the year.

First. There must be ten or less shareholders.¹⁰⁸ In the computation a husband and wife holding shares as community property, or joint tenants, tenants by the entirety or tenants in common, constitute one shareholder.¹⁰⁹ Shareholders must be individuals, estates or guardians.¹¹⁰ They may not be corporations, trusts or partnerships.¹¹¹

Second. Only one class of stock is permitted.¹¹² This means one class outstanding.¹¹³ The Treasury says that "if an instrument purporting to be a debt obligation is actually stock, it will constitute a second class of stock."¹¹⁴ If an electing small business corporation guesses wrong about whether a promissory note is really a debt or, for tax purposes, a contribution to capital, there is not just the repayment of principal problem¹¹⁵ or payment of interest problem,¹¹⁶ it may also lose its electing corporation status. If the corporation has outstanding debt securities, it should be noted that the Subchapter S election is risky.¹¹⁷

Third. The election can be made only within a two month period starting with one month prior to the beginning of the fiscal year and ending one month after the beginning of the year.¹¹⁸ All of the shareholders must consent to the election within that period¹¹⁹ and the election cannot be made later in the year. This limits the flexibility of Subchapter S as a substitute for Section 337. The sale has to be pending at or near the beginning of a new corporate tax year or Subchapter S will not be available. There is some chance of adjusting for this by using a long escrow or an option.¹²⁰ Another approach would be to close the sale on the installment method and thus receive the benefit of Subchapter S for all but the amount received in the year the sale closes; that is, the Sub-

¹⁰⁸ INT. REV. CODE OF 1954, § 1371(a)(1).

¹⁰⁹ INT. REV. CODE OF 1954, § 1371(c), adopted as Section 2 of PUBLIC CODE 86-376 (Sept. 23, 1959), 73 STAT. 699.

¹¹⁰ Treas. Reg. § 1.1371-1(d)(1).

¹¹¹ *Ibid.*

¹¹² INT. REV. CODE OF 1954, § 1371(a)(4).

¹¹³ Treas. Reg. § 1.1371-1(g).

¹¹⁴ *Ibid.*

¹¹⁵ *Ibid.*

¹¹⁶ *Ibid.*

¹¹⁷ It is significant to note that this problem was first pointed out by the present Commissioner of Internal Revenue in an article predating the regulation. Caplin, *The Caloric Count of a Thin Incorporation*, N.Y.U. 17TH INST. ON FED. TAX. 771, at 819 (1959).

¹¹⁸ INT. REV. CODE OF 1954, § 1372(e)(1).

¹¹⁹ INT. REV. CODE OF 1954, § 1372(a); Treas. Reg. § 1.1372-3(a).

¹²⁰ For methods of postponing a sale for tax purposes, see Stolzoff, *Tax Treatment of Escrow Adjustments in Real Property*, 1957 SO. CALIF. TAX INST. 737, 743-45.

chapter S election could be made for later years. This can also be used with deferred payment sales reported on the cost recovery method.¹²¹

Fourth. Maintaining eligibility throughout the year is a continuing problem. This problem must be taken into account in the advance planning for Subchapter S. The required status can be lost if any of the requirements mentioned above are not met at all times during the year.¹²² For example, a transfer of stock into a trust by any shareholder nullifies the election for all shareholders for the whole year.¹²³

A new shareholder will have to consent to the election within thirty days after he becomes a shareholder. If a shareholder dies, then the representative of his estate will have to consent to the election within thirty days after his appointment, but not later than thirty days after the close of the year.¹²⁴ This raises problems with respect to the executor's or administrator's authority under state law, because the estate can be adversely affected from a tax point of view.¹²⁵ For this reason, it is most important that each shareholder's will contain explicit instructions about Subchapter S elections. If the ESBC is depending upon the installment method of reporting income, which will require the continued eligibility of the status during the period of the installment obligation, then the estate may have to remain open for the same period if the will calls for distribution into a testamentary trust on the close of the estate. This raises problems about prolonging the administration of the estate for tax reasons.¹²⁶

Then there is always the problem of transferring the stock pursuant to attachment, execution or bankruptcy.¹²⁷ Here, an option to purchase held by the other shareholders may help.

Fifth. Gross income is an item to be watched. Loss of Subchapter S status results if an ESBC receives more than 20 per cent of its gross income in any one year from rents, dividends, interest, royalties or sales or exchanges of stock or securities by non-dealers (gross receipt from sale of stock or securities is only considered to the extent of gain realized from it).¹²⁸ The Committee Reports do not state the reason for this rule,

¹²¹ 1 RABKIN & JOHNSON, *op. cit. supra* note 47, at 4315-19.

¹²² INT. REV. CODE OF 1954, § 1372(e) (3).

¹²³ INT. REV. CODE OF 1954, § 1372(e) (1); Treas. Reg. § 1.1372-3(b). Of course, if the new shareholder is not an individual or an estate the corporation will cease to be eligible and the election will be terminated for the whole year. Note 122 *supra*.

¹²⁴ Treas. Reg. § 1.1372-3(b).

¹²⁵ For example, even if the corporation does not distribute any cash, a tax will be incurred by the shareholder-estate as a constructive dividend of the undistributed taxable income under Section 1373, requiring the estate to pay a tax even though it has not received any cash.

¹²⁶ See Treas. Reg. § 1.641(b)-3(a), (b) as to treatment of an estate which remains open solely for income tax purposes.

¹²⁷ If the tax consequences of terminating the election would be severe, an attaching creditor of any shareholder would be in a position to exercise considerable leverage.

¹²⁸ INT. REV. CODE OF 1954, § 1372(e) (5). Beside the limitation as to "Personal

but some believe it must be to prevent the creation of a personal holding company and then extracting fringe benefits or qualified benefit plans.¹²⁹

The installment method of reporting gain from the sale of corporate assets presents a problem with respect to the gross receipts. How is it to be measured? The problem is still more complicated if the property is sold subject to a mortgage or deed of trust.¹³⁰ The regulations provide that gross receipts mean "the total amount received or accrued under the method of accounting used by the corporation in computing its taxable income."¹³¹ They make it clear that this includes receipts on a sale where gain is not recognized, such as that under Section 337.¹³² The Regulation states:

Gross Receipts. (a) The term "gross receipt" as used in Section 1372(e) is not synonymous with "gross income." The test under Section 1372(e)(4) and (5) shall be made on the basis of total gross receipts, except that, for purposes of Section 1372(e)(5), gross receipts from the sales or exchanges of stock or securities shall be taken into account only to the extent of gains therefrom. The term "gross receipts" means the total amount received or accrued under the method of accounting used by the corporation in computing its taxable income. Thus, the total amount of receipts is not reduced by returns and allowances, cost, or deductions. For example, gross receipts will include the total amount received or accrued during the corporation's taxable year from the sale or exchange (including a sale or exchange to which Section 337 applies) of any kind of property, from investments, and for services rendered by the corporation. However, gross receipts do not include amounts received in nontaxable sales or exchanges (other than those to which Section 337 applies), except to the extent that gain is recognized by the corporation, nor does that term include amounts received as a loan, as a repayment of a loan, as a contribution to capital, or on the issuance by the corporation of its own stock.¹³³

It appears to mean that if the ESBC is using the installment method, that is the way the gross receipts are computed even though that may not be the ESBC's regular method of accounting. Example 1 shows that

Holding Company Income," the code also provides that the election shall be terminated if more than 80 per cent of the corporation's gross receipts are from sources outside the United States. INT. REV. CODE OF 1954, § 1372(e)(4).

¹²⁹ Price, *Subchapter S - Some Policy Questions*, 3 Tax Revision Compendium 1731, 1732 (Com. Print 1959). The American Bar Association, Section of Taxation, recommended in 1959 that a direct approach to the problem be taken by providing simply that during such time as an ESBC receives more than 20 per cent of gross income from such proscribed sources, no deduction will be allowed under Section 404(a) for a contribution to qualified pension or profit sharing plans. A.B.A. Section of Taxation, Program and Comm. Reports To Be Presented At The 20th Annual Meeting, 87-88 (1959).

¹³⁰ See SHAW, *WORKING WITH THE REVENUE CODE—1960*, 191-93 (1960).

¹³¹ Treas. Reg. § 1.1372-4(b)(5)(ii).

¹³² *Ibid.*

¹³³ *Ibid.*

a note is included at its face amount in gross receipts. Example 2 shows that if income is being reported on a percentage of completion method on a contract then only the portion of the contract price is included in the gross receipts. An argument can be made that one installment sale contract should be treated under rule 2, since Example 3, pertaining to installment sales, refers to a "corporation which regularly sells personal property on the installment plan, and appears to exclude a single sale."

In the case of a real estate corporation that wants the benefit of the installment method and thus cannot use Section 337, this ambiguity becomes crucial if income is expected from the proscribed sources. The attempted solution may require an installment obligation bearing no interest since interest income could constitute more than 20 per cent of the gross receipts depending on how they are measured. For example, if the installment method of computing gross receipts is not proper, and the corporation sold all its assets, the only gross receipts in future years would be the interest income. To say the least, this could lead to litigation.¹³⁴

If part of the income real estate is to be retained, then the rental income can disqualify the ESBC.¹³⁵ Income from hotels and motels is not "rent" within the Subchapter S definition, but income from apartment houses is "rent."¹³⁶

Getting property out of the ESBC can be a problem. Since cash distributions are the only kind which will reduce current earnings and profits,¹³⁷ the distributions will have to be in cash or face the fact that distributions in excess of current income will be taxed to the shareholders in the year of distribution if there is accumulated earnings and profits.¹³⁸ If the cash distribution were loaned back by the shareholders to the corporation, the step-transaction doctrine could be applied. It would be a distribution of a corporate obligation which is not a distribution of money.¹³⁹ Furthermore, if the "debt" is held to be equity capital, then two classes of stock may be in existence with consequent loss of Subchapter S status.¹⁴⁰

¹³⁴ If the obligation bears no interest it can be argued that in fact discount interest existed.

¹³⁵ In 1961, a bill was introduced in Congress to exclude rent as a proscribed type of income. H.R. 95, 87th Cong., 1st Sess. (1961).

¹³⁶ Treas. Reg. § 1.1372-4(b)(5)(iv).

¹³⁷ Treas. Reg. § 1.1373-1(d). Distributions in kind will be charged partially against current earnings and profits, if an amount of cash equal to current earnings and profits is not actually distributed during the year. Treas. Reg. § 1.1373-1(e)(2). See also § 1.1373-1(g) *Example* (3).

¹³⁸ See Treas. Reg. § 1.1373-1(g) *Example* (4).

¹³⁹ See Treas. Reg. § 1.1373-1(d), to the effect that a distribution of a corporate obligation is not a distribution of cash.

¹⁴⁰ See Treas. Reg. § 1.1371-1(g).

CONSEQUENCES OF LOSING SUBCHAPTER S STATUS

Loss of ESBC status dates back to the beginning of the year, which means that the unfortunate business will be treated as a regular corporation for that whole year and taxed as such. Internal Revenue audits lag in time and this could mean the lapse of a number of years before anyone realizes that ESBC eligibility has been lost. The corporation, in that period, might well have distributed much cash as dividends and incurred corporate tax. The distributions would not qualify for capital gain treatment. Furthermore, if the ESBC status is lost, undistributed taxable income becomes locked in;¹⁴¹ and if a shareholder dies, his share of previously taxed income is not available for tax free distribution.¹⁴² The American Bar Association has recommended an amendment to alleviate these risks by permitting the distribution of previously taxed income to successors in interest at any time, and by allowing cash to be put back into the corporation,¹⁴³ if it subsequently proves to have been ineligible to be an ESBC.

Subchapter S, therefore, is limited to those instances where timing and eligibility will permit. It is crucial to plan carefully and realistically to see to it that the corporation is eligible to be an ESBC and that it will continue to be throughout its expected life.

USING SUBCHAPTER S WITH SECTION 337

It may be useful to consider these two approaches together. Under the best of circumstances, doubt frequently exists as to whether Section 337 has been complied with in the presence of the collapsible horror or even in the technical compliance with respect to the plan or the 12-month requirement.

The combination of the two provisions can have advantages in two situations; namely, the collapsible corporation context and where there are non-qualifying sales under Section 337.

Where there is doubt about the corporation's collapsible status with consequent doubt about whether Section 337 applies, tax at the corporate level can still be avoided by means of electing the Subchapter S status on sale of the corporate assets. If Section 337 does not apply, then the income will be taxed through to the shareholders. This will increase the basis in their stock, which, in turn, will reduce capital gain on distribution to them of the corporate assets. Thus, they pay the same amount of tax assuming that the sale of the assets qualified as capital gain. For an

¹⁴¹ Distribution of previously taxed income cannot be made tax free out of income taxed in any year during which or prior to which the election was not in effect. INT. REV. CODE OF 1954, § 1375(d)(2)(A); Treas. Reg. § 1.1375-4(a).

¹⁴² Treas. Reg. § 1.1375-4(e).

¹⁴³ ABA SECTION OF TAXATION, *op. cit. supra* note 129, at 88-90, 92-93.

ESBC, determination of the character of the gain is generally made at the corporate level except where the corporate asset sold is one which in the hands of a substantial shareholder would have been a "dealer" item. If the asset were a "dealer" item in the corporation's hands, as it might well be in the case of a collapsible asset, or if it were a "dealer" item in the hands of a substantial shareholder, then the gain from the ESBC sale would be taxed to the shareholders as ordinary income under the current Regulation Section 1.1375-1(d) which, as has been noted, lacks any code support.

If it should turn out that Section 337 did apply, then the gain on the sale of corporate assets would not be recognized by the corporation, and, therefore, would not be taxed through to the shareholders even though Subchapter S had been elected. Since the taxable income of an ESBC is computed in about the same way as that of a regular corporation, with some exceptions, the shareholders would face no additional tax.

This hedge of Subchapter S against denial of Section 337 treatment can be particularly useful where the corporation fears collapsible status by virtue of the attribution rules of Section 341(e)(10).¹⁴⁴ The ESBC has an advantage here because its Regulation Section 1.1375-1(d) purports to determine the character of the gain by considering only the dealer status of the actual shareholders themselves, whereas Section 341(e)(10) sends one on an almost hopeless investigation of the activities, not only of the shareholders, but of their relatives and other corporations as well.¹⁴⁵

The combination of Subchapter S and Section 337 has advantages in the case of a corporate sale of assets using the installment method of reporting income and electing Subchapter S, and liquidating in the year following the sale. If it should turn out that Section 337 does not apply, then all of the deferred gain on the installment obligation would be accelerated and recognized by a regular corporation when it distributed the obligation on liquidation to the shareholders.¹⁴⁶ Under Section 453(d)(1), the distribution would be considered a disposition of the installment obligation and, by our premise, the relief provision of Section 453(d)(4)(B)¹⁴⁷ relating to Section 337 liquidations would be unavailable.

¹⁴⁴ See note 20 *supra*.

¹⁴⁵ Usually, if the corporation's chief assets were not dealer assets in either the corporation's hands or in the hands of a substantial shareholder, Section 341(e) would apply to remove the collapsible taint. However, 341(e) may not be applicable by reason of the activities of a person to whom 20 per cent ownership of stock is attributed under § 341(e)(10).

If assets are to be sold then not only must the requirements of § 341(e) as to dealer assets be complied with, but the restrictions of § 341(e)(4) must be observed. Otherwise § 337 will still not apply. Therefore, if the corporation did not desire to sell all of its assets, as required by § 341(e)(4)(B), Subchapter S will allow the sale of assets to be made at the price of only one capital gains tax at the shareholder level.

¹⁴⁶ INT. REV. CODE OF 1954, § 453(d)(4)(B), provides that deferred gain in an installment obligation is not accelerated to the corporation when § 337 applies.

¹⁴⁷ Since the gain to the corporation on the distribution of the installment obligation

In other words, the corporation would find itself back in the *Court Holding Co.* situation. If, however, the corporation elects to be an ESBC and liquidates in the year following the closing of the sale, then the deferred gain on the installment obligation which would be accelerated by the liquidating distribution would be taxed through to the shareholders without tax at the corporate level. Furthermore, it would be possible to escape the "dealer" net of Regulation Section 1.1375-1(d) because the assets would have been sold prior to ESBC status, and the character of the gain, capital gain or ordinary income, would be determined as of the date of sale.¹⁴⁸ At that date, Regulation Section 1.1375-1(d) would not apply since the corporation would not yet have elected Subchapter S. Thus, it would be possible for the "dealer" shareholders to realize capital gain passed through to them by virtue of its capital gain character determined at the corporate level without regard to the shareholders' dealer activities.

The combination can be useful even where Section 337 does clearly apply but where there are elements in the transaction which do not qualify for Section 337 protection (e.g., a sale of inventory in the ordinary course of business) and it is desired to avoid tax at the corporate level on the gain from such transactions. Subchapter S can be used to avoid tax at the corporate level in the final year or the last two years depending upon the timing.

Whether the use of Subchapter S with Section 337 will reduce or increase the total tax on the entire sale and liquidation is a matter of arithmetic to be worked through in each case. But in evaluating the use of Subchapter S, whether it is being used as a hedge or only to avoid a corporate tax on income received in the final year, it is imperative to consider the risk of the dealer status of a substantial shareholder being imputed to the corporation under Regulation Section 1.1375-1(d) resulting in ordinary income treatment on some sales which would have been capital gain transactions for a nonelecting corporation. Even though Regulation Section 1.1375-1(d) may have tenuous status, the hazard it presents should be considered. Electing Subchapter S in the wrong case can result in all the gain taxed as ordinary income to the individual

results from the provisions of §453(d), the character of the gain should be determined under that section.

Section 453(d) provides in part: "Any gain or loss so resulting shall be considered as resulting from the sale or exchange of the property in respect of which the installment obligation was received."

The Commissioner would be free to contend that the dealer activities of a substantial shareholder should be attributed to the corporation in the year the sale closes under general principles, apart from the provisions of Subchapter S or collapsible corporations. See, e.g., *Ralph A. Gordy*, 36 T.C. No. 84 (August 17, 1961).

¹⁴⁸ See *Providence Trust Company of Philadelphia*, 29 B.T.A. 374, *aff'd* 76 F.2d 810 (3d Cir. 1935), 15 AFTR 1246, 35-1 USTC § 9230; *Alexander M. Crane*, 30 B.T.A. 29, *aff'd* 76 F.2d 99 (2d Cir. 1935), 15 AFTR 391, 35-1 USTC § 9204. See also H.R. Rep. No. 2, 70th Cong., 1st Sess. 11-12 (1928).

shareholders when the security of a 43 per cent maximum tax would have been more economical.¹⁴⁹

CONCLUSION

The expressed intention of Congress in connection with both Section 337 and Subchapter S has been to do away with formalities. But Congress has really not properly worked through a satisfactory relationship between Subchapter S and Subchapter C and the collapsible problem. By virtue of this failure, there has been superimposed upon the problem of preventing a double tax on the sale of corporate assets in liquidation all of the formalities mentioned in this article. This result was certainly not intended by Congress for it would be difficult to grasp what legislative policy is served by the gymnastics of Subchapter S being combined with the technicalities of Section 337 in order to avoid the impossible collapsible corporation provisions. So long as that provision can operate to deprive taxpayers of the relief of Section 337, then it is clear that taxpayers will resort for protection to Subchapter S, which is still another entity, created obviously for other purposes; and created without proper analysis by Congress of the relationships involved. When it is considered that the basic problem remains unchanged—a sale by a corporation of its assets followed by a distribution to its shareholders—and that the substantive non-tax aspects of the transaction remain unchanged no matter which of the formalities is adopted for tax purposes, it follows that what started as a drive toward reality has become a morass of formality; and it will be cured by nothing less than an organized revision of the total treatment of corporate distributions.

¹⁴⁹ See note 23 *supra*.